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Conflict of Laws - Penal Provisions in Foreign Law - Liability of Shareholders in De Facto Corporation

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CONFLICT OF LAWS—PENAL PROVISIONS IN FOREIGN LAW—LIABILITY OF SHAREHOLDERS IN DE FACTO CORPORATION—Defendants, residents of Tennessee, while attempting to form a corporation under the laws of Arkansas,¹ inadvertently failed to file the articles of incorporation with the county clerk, although they were filed with the Secretary of State of Arkansas. The resulting business association was an Arkansas de facto corporation.² Under Arkansas law the shareholders of a de facto corporation are personally liable for the debts of the corporation.³ Plaintiff, a creditor who dealt with the corporation, sued in a Tennessee court and asked that the Arkansas rule be applied. The trial court refused to do so on the ground that it was penal in nature, and applied instead the Tennessee rule that shareholders of a de facto corporation are not personally liable for its debts. On appeal, *held*, affirmed.⁴ Plaintiff petitioned for rehearing, alleging conflict with the decision of the Court of Appeals for the Sixth Circuit in *Doggrell v. Great Southern Box Co. of Mississippi*,⁵ which held in deciding the same question that the Arkansas rule was not penal and the courts of Tennessee were therefore bound to apply it by the "full faith and credit"

¹ Ark. Stat. Ann. (1947) §64-103. "Upon the filing with the Secretary of State of articles of incorporation, the corporate existence shall begin. Provided, however, a set of the Articles of Incorporation . . . shall be filed for record with the County Clerk. . . ."

² A de facto corporation is formed if (a) there is a law in the state of alleged incorporation under which such corporation might be formed, (b) there is colorable or apparent intent, (c) in good faith to incorporate under such law, and (d) there is some corporate user. Frey, "Legal Analysis and the 'De Facto' Doctrine," 100 UNIV. PA. L. REV. 1153 (1952).

³ *Whitaker v. Mitchell Mfg. Co.*, 219 Ark. 779, 244 S.W. (2d) 965 (1952). Whitaker, an Arkansas resident shareholder of the corporation involved in the principal case, was held personally liable for the debts of the de facto corporation. Arkansas is one of the few jurisdictions so holding.

⁴ Tennessee courts will apply the law of the state in which the corporation is domiciled unless that law is penal in nature. *Sullivan v. Farnsworth*, 132 Tenn. 691, 179 S.W. 317 (1915).

⁵ (6th Cir. 1953) 206 F. (2d) 671.

clause of the Constitution.⁶ *Held*, petition denied. Under the test applied by the federal court, as construed by the Tennessee court, the Arkansas rule is penal in nature and against the public policy of Tennessee. *Paper Products Co. v. Doggrell*, 195 Tenn. 581, 261 S.W. (2d) 127 (1953).

There are three choice-of-laws theories operating in the courts of the United States today: comity (employed by the Tennessee court), vested rights, and the local law theory.⁷ By the use of these theories a court will at the proper times decide a case as it would be decided in the courts of a foreign state. If the rule of the foreign state is penal in nature the time is not proper.⁸ This is the real basis for the court's decision in the principal case.⁹ There are two major tests used by the courts to determine the penal nature of a foreign rule: (1) the test proposed in the leading case of *Huntington v. Attrill*,¹⁰ i.e., that a rule is penal when the offense proscribed is against the state and when the state alone can sue an offending party, and (2) the test whereby any allowable recovery which is more than compensatory is penal.¹¹ The court in the principal case, though purporting to apply the *Huntington* test, actually responded to its own inclinations in concluding that the Arkansas rule is penal in nature.¹² The court said that the Arkansas rule has been formulated solely to enforce compliance with the Arkansas corporation statute¹³ and is therefore penal.¹⁴ The court also emphasized the fact that the plaintiff dealt with the association as a corporation.¹⁵ It has also been held that a de facto corporation under the

⁶ "Full faith and credit shall be given in each State to the public acts, records, and judicial proceedings of every other State." U.S. CONST., art. IV, §1. The court relied upon *Broderick v. Rosner*, 294 U.S. 629, 55 S.Ct. 589 (1935), which held state statutes to be entitled to "full faith and credit" in other states unless they are penal or contrary to the public policy of the latter state.

⁷ Cheatham, "American Theories of Conflict of Laws: Their Role and Utility," 58 HARV. L. REV. 361 (1945).

⁸ "The courts of no country execute the penal laws of another." Marshall, C.J., in *The Antelope*, 10 Wheat. (23 U.S.) 66 (1825).

⁹ The court said also that the Arkansas rule was contrary to the public policy of Tennessee, because the Tennessee rule was different. That this reason is not valid, see *Loucks v. Standard Oil Co.*, 224 N.Y. 99, 120 N.E. 198 (1918).

¹⁰ 146 U.S. 657, 13 S.Ct. 224 (1892). This case is controlling in all suits in one state on judgments obtained in another state under the "full faith and credit" clause. The foreign law must be penal in all respects: *Great Western Machinery Co. v. Smith*, 87 Kan. 331, 124 P. 414 (1912). See also Leflar, "Extrastate Enforcement of Penal and Governmental Claims," 46 HARV. L. REV. 193 (1932), for a survey of the common situations presenting problems as to when a law is penal.

¹¹ *McLay v. Slade*, 48 R.I. 357, 138 A. 212 (1927).

¹² The court cited *Woods v. Weeks*, 75 Tenn. 40 (1881), as controlling. This case held to be penal a New York statute which made shareholders of a de jure corporation personally liable for the debts of the corporation because of an omission of its directors.

¹³ See note 1 supra. The court relied on the statement that corporate existence begins upon filing the articles of incorporation with the secretary of state. What, then, is the effect of the second sentence quoted?

¹⁴ It is submitted that limited liability can be achieved only by compliance with the corporation statute, and therefore the logical result of non-compliance is personal liability. Query whether this result is penal?

¹⁵ That this may often be the basis for limiting the liability of shareholders of a de facto corporation, see Frey, "Legal Analysis and the 'De Facto' Doctrine," 100 UNIV. PA.

laws of one state should be treated as a domestic de facto corporation in another state.¹⁶ While this doctrine might have justified the decision in the principal case, it should be noted that its utilization would render unnecessary any application of a test as to the penal quality of the foreign law. Adherence to the test of penalty formulated in the *Huntington* case would do much to promote uniformity in choice-of-laws decisions. It is submitted, however, that a literal application of the "full faith and credit" clause would afford the best method of achieving this objective.¹⁷

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L. REV. 1153 (1952). See also the dissenting opinion in *Doggrell v. Great Southern Box Co.*, (6th Cir. 1953) 206 F. (2d) 671.

¹⁶ *First Title and Securities Co. v. U.S. Gypsum Co.*, 211 Iowa 1019, 233 N.W. 137 (1930). This case should be compared with *Reed v. Appleby*, 150 Tenn. 63, 262 S.W. 35 (1923). In that case the Tennessee court applied an Oklahoma statute prohibiting a collateral attack on an Oklahoma corporation's organization (a statute peculiarly applicable to de facto corporations). The court emphasized, however, the fact that Tennessee had a similar statute, thus implying that in the absence of a similar local rule, local law would be applied to a de facto corporation. See also the dissent in *Doggrell v. Great Southern Box Co.*, note 15 supra.

¹⁷ See Jackson, "Full Faith and Credit—The Lawyer's Clause of the Constitution," 45 COL. L. REV. 1 (1945).